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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	
Price Cap Performance Review for Local Exchange Carriers	CC Docket No. 94-1
Treatment of Operator Services Under Price Cap Regulation	CC Docket No. 93-124
Revisions to Price Cap Rules for AT&T	CC Docket No. 93-197

REPLY COMMENTS OF PACIFIC BELL AND NEVADA BELL

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Summary

Our competitors object strenuously to the Commission's proposals. They object to statements of economic principle that are unobjectionable. They would condition even modest reforms of price cap rules on criteria that have no relationship to the rationale for price cap regulation. In some cases they object to aspects of the Commission's proposal, or the LECs', that do not exist.

At the risk of telling the Commission what it already knows, in these Reply Comments we will try to set the record straight on the economic issues that our competitors have introduced. Many of these issues happen to be irrelevant to our proposal for price cap reform and contract-based pricing. But it is important for the Commission to be informed about economic principles now, because in the coming years it will have to deal with issues (such as the RBOCs' entry into the interLATA market) we previously only dreamed of. Before it tilts at "entry barriers" or "essential facilities," for example, the Commission needs to know how economists and antitrust courts have defined them. Before it appraises market power, it must decide, not as regulators are used to deciding but as economists and businesspeople decide, what a market is. (The answer is not in Part 69.)

Despite the reservations we expressed in our Comments, we are more impressed by the direction of the Commission's proposal than our competitors seem to be. In many respects, as we have pointed out, our own proposal is less of a departure from precedent than the Commission's. It comprises modest changes to price cap baskets and bands, supported by cross-elasticity principles; a very measured amount of geographic deaveraging, along the lines already accepted for trunking; the freedom to introduce new services without heightened scrutiny; and the ability to do

business under integrated, nondiscriminatory contracts (as well as under tariff) in clearly delineated competitive areas.

Consumers would benefit from more geographic deaveraging under price caps. Currently, as one of our competitors points out (albeit unintentionally), hundreds of millions of dollars of downward pricing flexibility goes "unemployed" because today's price cap rules present carriers with only two choices, neither of which is rational: reduce prices *everywhere,* including the prices that are already too low; or do not reduce prices *anywhere,* surrendering low-cost markets to competitors who may be less efficient. Allowing the same limited amount of geographic deaveraging for all price cap baskets as the trunking basket now enjoys would encourage competitive price reductions while discouraging inefficient entry.

Sprint has advanced an interesting proposal to reduce the residual interconnection charge on transport (the "RIC") by the difference between the productivity factor and the GDP-PI. Currently, this productivity reduction is applied, arbitrarily and indiscriminately, to all baskets. Though the Commission has never openly acknowledged it, the RIC is a contribution element. It was amply justified by the contribution that switched access historically has provided to total costs. But that contribution is now at risk from competition. And, because "contribution" is the difference between economic cost and price, the Commission's current inquiry into what costs the RIC "recovers" is misguided -- in fact, except by reference to fully distributed costs, it is unanswerable. Sprint's proposal deserves consideration as one way out of this impasse.

Our competitors contend that further pricing flexibility would allow us to cross-subsidize more competitive services with revenues from less competitive services, or to leverage our "bottleneck" to discriminate against other providers. We discuss in our Reply Comments why these suggestions are disingenuous, implausible, or both. Our proposal also moots them. Access services

would available for sale under contract only after a competitive showing. The contracts would be available to all similarly situated customers, and the services could be freely resold. Perhaps the most important safeguard in our proposal would be the continuing availability of access services from price capped tariffs, even in competitive areas.

We also attach testimony to the CPUC by Dr. Robert Harris, and an agreement to provide unbundled loops to MFS, that demonstrate the rivalrous state of competition in California. The Commission has proceeded too long on the assumption that one set of rules works equally well in every access market. In the future, California promises to be one of the most (if not *the* most) competitive telecommunications markets in the world. Our competitors are wrong to suggest that effective competitive has not developed anywhere, but more important, they have misstated the issue. In the uneven competitive landscape of the future, regulation must adapt to competition in specific markets. Our proposal -- and to a lesser degree the Commission's -- recognizes this principle.

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REPLY COMMENTS OF PACIFIC BELL AND NEVADA BELL

Pacific Bell and Nevada Bell ("Pacific") hereby respectfully reply to the comments on the Commission's *Second Further Notice of Proposed Rulemaking* (the "*Second Notice*") in the above-captioned proceeding.[1]

Comments were filed by, among others: the Ad Hoc Telecommunications Users Group ("Ad Hoc"); AT&T Corp. ("AT&T"); the Association for Local Telecommunications Services ("ALTS"); the Bell Atlantic telephone companies ("Bell Atlantic"); Comcast Corporation ("Comcast"); Competitive Telecommunications

[1] *Price Cap Performance Review of Local Exchange Carriers, Treatment of Operator Services Under Price Cap Regulation, Revision of Price Cap Rules for AT&T,* CC Docket Nos. 94-1, 93-124, 93-197, Second Further Notice of Proposed Rulemaking in CC Docket No. 94-1, Further Notice of Proposed Rulemaking in CC Docket No. 93-124, and Second Further Notice of Proposed Rulemaking in CC Docket No. 93-197, FCC 95-393 (released September 20, 1995).

Association ("CompTel"); Cox Enterprises, Inc. ("Cox"); the General Services Administration ("GSA"); ICG Access Services, Inc. ("ICG"); the Information Industry Association ("IIA"); the Information Technology and Telecommunications Association ("TCA"); LCI International, Inc. ("LCI"); LDDS WorldCom; MCI Telecommunications Corporation ("MCI"); the National Cable Television Association ("NCTA"); Sprint Corporation ("Sprint"); Sprint Telecommunications Venture ("STV"); Telecommunications Resellers Association ("TRA"); Teleport Communications Group Inc. ("TCG"); Time Warner Communications Holdings, Inc. ("Time Warner").

Many of these parties raised issues far outside the scope of this proceeding -- for example, alleging that other LECs have behaved anticompetitively. We respond only to the most germane and important issues below.

I. Prelude: Efficient and Inefficient Entry

The *Second Notice* is premised on what economists such as Prof. Kahn call the "competitive standard" -- the assumption that where regulation is necessary, it should seek "to promote economic efficiency, which includes regulating prices so that they emulate the economic performance of competitive markets as closely as possible until actual competition arrives."[2]

[2] Alfred E. Kahn and Timothy J. Tardiff, "Changes in Interstate Price Regulation: An Economic Evaluation of the Pacific Bell and Nevada Bell Proposal," December 11, 1995, p. 1 ("Kahn-Tardiff Report").

That some commenters do not understand what economic efficiency *is* says a great deal about how far the Commission has to go. For example, ALTS complains that the Commission's

> concern about benefiting consumers "indirectly by encouraging only efficient entry," is profoundly puzzling. Assuming for the sake of argument that the Commission really has the ability to lure competitive companies into "inefficient entry" (an assumption which ALTS vehemently disputes ...), how could prevention of that entry ever benefit an access consumer?
>
> It may well be that the investors in a competitive entity, or in the LEC it chooses to compete with, might well be harmed as a result of an imprudent decision to enter a market. But the Second NPRM does not claim to be protecting competitive investors or LECs from unwise decisions. Instead, it speaks only in terms of consumer welfare, and it is manifest that consumers always benefit from competitive entry, no matter how imprudent any particular entry proves to be.

(ALTS, p. 10; emphasis in original; internal citation omitted.)

Inefficient entry has nothing to do with "imprudent" investment decisions, and consumers do not "always benefit from competitive entry." When access prices are kept artificially high -- as they are by prohibitions on volume discounts and other forms of differential pricing, geographic deaveraging, contract-based pricing, etc. -- our competitors are encouraged to enter markets where they may not be the most efficient providers, and to set their prices just below the artificially controlled price. Telecommunications consumers suffer directly from such "umbrella pricing" because they pay more, or get less, than they would absent price controls. Society suffers because artificially set prices -- whether high or low -- deter *prudent* investors from investing in the enterprises that will most efficiently produce the things that consumers want to buy. As Prof. Kahn wrote of the "systematic *over*charging for long distance calling" when it was price-controlled in much the same way

as access remains price-controlled today, "[t]he loss is real. Eliminating [such] inefficiencies would improve total welfare in exactly the same way as giving people billions of dollars more income."[3]

It is encouraging that the Commission has come so far as to acknowledge that inefficient entry harms consumers. But it is profoundly discouraging that any party to this proceeding should contend, apparently in all seriousness, that artificially controlled prices are good for consumers insofar as they encourage more suppliers to enter the market. Such a contention displays either disregard for, or ignorance of "competition's basic goals -- lower prices, better products, and more efficient production methods."[4]

II. The Need for Greater Pricing Flexibility and Geographic Deaveraging

While some competitors argue that greater pricing flexibility *will harm consumers,* others assert that greater pricing flexibility is unnecessary because *competition for access services does not exist.* This contention is irrelevant (and, as we show later, incorrect). Price cap regulation was never intended to coexist with effective competition. Price cap regulation was intended to "facilitate more efficient pricing by LECs and remove incentives for inefficient entry." (*Second Notice,* para. 34.) The existence of competition would be an irrational condition for reforms to price cap regulation. Everyone acknowledges, on the other hand, that competition should be a condition of price *de-*regulation. To our knowledge, no LEC has suggested that price controls should be lifted on

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[3] Alfred E. Kahn and William B. Shew, "Current Issues in Telecommunications Regulation: Pricing," Yale J. on Regulation, vol. 4, no. 2 (1987), pp. 209-210 (emphasis in original).

[4] See *Town of Concord, Mass. v. Boston Edison Co.*, 915 F.2d 17, 21 (1st Cir. 1990) (Breyer, J.).

any services currently subject to price cap regulation without a competitive showing. Whether, where, and how much competition exists are interesting questions, but the Commission need not resolve them before putting in place a program that adapts to changes in the marketplace.

One misconception should be put to rest. ALTS claims that downward pricing flexibility must not be necessary (or, the LECs must not face meaningful competition), because "the LECs already possess considerable price reduction flexibility which they have not employed." (ALTS, p. 9.)

"Unemployed" downward pricing flexibility does not indicate the absence of competition. It is an artifact of price controls, and merely demonstrates the need for greater pricing flexibility (in particular, geographic deaveraging). The current system of price regulation contains two significant limitations on, or disincentives to, the use of downward pricing flexibility. The first is a matter of arithmetic: the rules generally allow price reductions to be offset by price increases only in the same band or basket. In Zone 1, this prevents us from exercising the full degree of downward pricing flexibility (15% per year) that the Commission theoretically allows us.

The second limitation is the requirement (with the single exception of zone pricing for trunking) to charge the same rate throughout a study area. Prices may be equal across a study area, but costs are not. Competition does not pay attention to study area boundaries. It is attracted first to the dense markets where the difference between the marginal cost and the regulated price is greatest. Even if there were no other restrictions on downward pricing flexibility, geographic averaging would prevent us from reducing prices

to meet competition in geographically limited markets unless we were willing to reduce prices everywhere.

The problem with the geographic averaging requirement is thus painfully obvious. It allows only two choices, neither of which is rational: reduce prices *everywhere,* including the prices that are already too *low;* or do not reduce prices *anywhere,* pointlessly surrendering low-cost markets to competitors. Far from demonstrating that we have market power, the difference between the theoretical minimum prices that the Commission's rules allow us, and what the Commission's rules actually make possible and rational for us to charge, is direct evidence of the distorting effect of price controls and the need for price cap reforms. As the Commission itself acknowledges, combining service bands "might immediately [be expected to] result in lower rates for certain competitive access services." (*Second Notice,* para. 83.)

In our Comments, we propose a modest amount of geographic deaveraging for services that continue to be price capped. We suggested that all price cap baskets be allowed the same limited degree of geographic deaveraging as the trunking basket. In competitive areas, rational price changes should be encouraged by letting us provide access under contract. This is a freedom our competitors enjoy everywhere. In California, we have been able to provide competitive services like special access under contract for years.

III. Pacific's Proposal

A. *Integrated Service Contracts*

For reasons described in the Kahn-Tardiff Report that we submitted with our Comments, our proposals for price cap reform and contract-based pricing are consistent with price cap principles and the competitive standard. For any area where we can demonstrate

that consumers have competitive choices, we should be allowed to provide all access services under integrated contracts. The contracts would be filed with the Commission, which would not regulate the price directly but would have the option, if cost standards are not met, of rejecting them. This system has operated successfully in California for years. It has been an important factor in creating the rivalrous competition that now exists here.

As customer contracts are signed, any initial price reductions could be reflected in the price caps of tariffed services to the degree that the price cap formulas allow. This is essentially the same approach the Commission has taken to AT&T's consumer discounts and promotions. Subsequent renewals of the contract would not, however, result in further adjustments to price caps. Contract terms would be generally available to all similarly situated customers, there would be no limits on resale of access services provided under contract, and the option of ordering access services from general price-regulated tariffs would remain available to all customers in all areas.

B. *Geographic Areas*

We continue to support price deregulation at the level of the wire center. Because competitive wire centers tend to be contiguous, the number of competitive showings that would be filed under a wire center proposal would be fairly small. We have also proposed applying the density price zones established for transport to all price capped services. There is simply no other generally accepted geographical delineation that works as well. Ad Hoc, for example, suggests that the Commission should use either LATA or tandem areas as relevant markets instead. (Ad Hoc, p. 30.) But competition does not respect LATAs or tandem serving areas. It develops in relatively low cost, high revenue areas, that is, areas with dense business and residential populations. Such areas seldom, if

ever, correspond closely to LATAs or tandem serving areas. The conditions that attract competitive entry to downtown Los Angeles are not the same as the conditions in Death Valley -- but they are both in California's LATA 5. Nor are the conditions in the dense Orange County business district the same as in Death Valley -- but both areas home on the Anaheim tandem. In California, the fifty end offices with the greatest traffic volume home on seventeen different tandems. (We have only nineteen tandems in total.) Similarly, the 200 offices with the smallest traffic volumes home on eighteen different tandems.

Some parties might object to using density pricing zones for any services other than trunking, on the basis that no other services have the same cost characteristics. However, the differences in cost characteristics are too small to warrant creating entirely new sets of zones for services (such as switched and special access) that are highly cross-elastic to begin with. As NECA showed in its Comments in CC Docket No. 80-286, "switching costs per unit of demand increase as switch size decreases.... Rural areas in fact lack the economies of scope and scale that characterize urban, high-density areas and this results in higher switching costs."[5]

As we reminded the Commission in our Comments, the current zones are a blend of special and switched density. This was justified based on the high overlap between the density of switched and the density of special traffic. We found that there is a 78% correlation between the number of local switching minutes in an office (*i.e.*, how it would be zoned if switching alone were considered) and its current ranking into Zone 1, 2, or 3 for trunking. There is an 80% correlation between the number of business access lines

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[5] Comments of NECA, CC Docket No. 80-286, filed October 10, 1995, p. 30.

(including Centrex) in an office and its trunking zone. There is a similar overlap between loop length and trunking zones. Zone 1 offices have, on average, shorter (therefore cheaper) loops than Zone 2; Zone 2 offices have shorter, cheaper loops, on average, than Zone 3. Creating different sets of zones for products that are highly cross-elastic, and that furthermore share roughly the same cost characteristics, would serve no purpose except to confuse customers and make the administration of zone price caps far more burdensome.

C. *The Productivity Factor*

Sprint proposes that the difference between the productivity factor and GDP-PI be targeted to eliminate or at least reduce the portion of the residual interconnection charge (RIC) that is not associated with tandem switching costs. (Sprint, p. 10.) Sprint also proposes that price cap LECs be allowed to disaggregate RIC charges into zones and apply the annual reduction from the productivity offset first in those areas where rates are most out of line with costs, and subsequently eliminate the RIC in other zones. (Id.)

We endorse Sprint's proposal to target the (GDP-PI - X) portion of the PCI formula for all baskets to the RIC. We also agree that we should have the option to target the reduction to those areas where rates are most out of line with costs, *i.e.,* Zone 1, then Zone 2, and finally Zone 3.

In the table below we display several different ways that Sprint's X factor concept could be employed to reduce the RIC. The X factor used is the one current no-sharing option (5.3%). The revenue values we used for the revenue base and the current RIC are taken from Pacific Bell's most recent annual filing. The revenue figures for tandem and port costs are very close approximations of the actuals.

This table depicts two different scenarios, each having two options. The first scenario initially reduces the current RIC by reassigning tandem and port costs to discrete rate elements. The tandem cost figure represents 80% of the Part 69 tandem cost assigned to the RIC in Docket 91-213. The port costs are those of the equipment (digital carrier trunk, plug-ins, controller, digroup buffer, and so forth) needed to break a DS1 down so that it can be processed by the switch. Our analysis shows that at its current rate of about $35M a year, the productivity factor minus GDP-PI would wipe out the remainder of the RIC, $58M, in about two years. A more refined oftion would eliminate the entire RIC in Zone 1 and almost all the RIC in Zone 2 in the first year, and the remaining RIC in Zones 2 and 3 in the second year.

The second scenario performs the same calculations, but without the reassignment of tandem costs. This option would probably be more attractive to IXCs that use tandem transport predominantly. In this scenario, the RIC would be eliminated within three years when applying the offset across the board, that is, without zone targeting. With zone targeting, the RIC in Zone 1 would be eliminated and the RIC in Zone 2 would be cut by approximately a third in the first year; eliminated in Zone 2 and more than halved in Zone 3 in the second year; and eliminated completely in the third year.

Though it has been addressed to date only in Docket 91-213, the RIC "problem" could be solved along these lines with relative ease and rough justice. Parsing the RIC into its cost components would consume significant time and resources, would be extremely contentious, and would still not result in a better resolution than the one that Sprint has proposed or the ones that we have outlined here.

FIGURE 1: RIC Reduction by Targeting Productivity Factor

Productivity Offset Calculation *	
Estimated GNPPI	3.10%
Less Productivity Factor	-5.30%
Difference	-2.20%
Approximate Annual Revenue (M)	$1,600
Productivity "Offset" Annual Revenue (-2.2% 1,600M)	($35)

Scenario 1 - Tandem and Port Cost Reassigned	Total	Zone 1	Zone 2	Zone 3
Current Approximate RIC**	$117	$39	$39	$39
Less Tandem Cost	(25)			
Less Port Change	(25)			
RIC Remainder	57	19	19	19
Less Productivity 'Offset'				
RIC Remainder After Year One	22	0	3	23
Less Productivity 'Offset'	(23)			
RIC Remainder After Year Two	$0	0	0	$0

Scenario 2 - Only Port Cost Reassigned				
Current Approximate RIC	$118	$39	$39	$39
Less Port Change	(35)			
RIC Remainder	83	27	28	28
Less Productivity 'Offset'	(35)			
RIC Remainder After Year One	48	0	20	32
Less Productivity 'Offset'	(35)			
RIC Remainder After Year Two	13	0	0	13
Less Productivity 'Offset'	(13)			
RIC Remainder After Year Three	$0	0	0	$0

* Note: In this example exogenous changes are assumed to be zero.
** Note: For illustrative purposes, the RIC was divided equally among the three zones.

Ad Hoc says that "[t]he RIC also reflects the fundamental lack of competition in the switching market." (Ad Hoc, p. 29.) The RIC produces a problem for us *because* of competition. The RIC is, by any other name, a contribution element. It was amply justified by the greater contribution that switched access historically made to total costs. But that contribution is now threatened by competition from special access and alternative providers, and is undermined by the absence of zone pricing for switching. Over and above other price controls, geographic averaging of the RIC gives switched access customers in low-cost, highly competitive areas an artificial incentive to substitute special access or leave the switched network entirely. In the long term the problem will be solved by lifting price controls. In the short term, while there may be no ideal solution, Sprint's proposal, or something close to it, would at least address the problem constructively.

D. *Our Proposal Moots The Competitive Concerns of our "Customers"*

Below, we respond generally to contentions that increased pricing flexibility for the LECs would harm competition. We hope that much of what we say will be self-evident. However obvious the points below may seem to the Commission, our competitors have put them in contention.

As an additional preface, we remind the Commission that for reasons set out in the Kahn-Tardiff Report, our proposal moots all of the "competitive harm" issues that we discuss in the following pages.[6] With the safeguards we have suggested, our plan would create no potential for competitive harm. Nor would it represent a marked change from any Commission policy or precedent.

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[6] Additionally, in Attachment A to these Reply Comments, Dr. Tardiff addresses the irrelevance of Dr. Bernheim's (AT&T's) analysis to our proposal.

It is significant that, among the parties filing comments, the only *customer* who is not also a competitor -- the GSA -- is generally supportive of the Commission's proposals to reform price caps and streamline competitive services. It is equally revealing of the competitive landscape that a competitor-customer like AT&T now *supports* rules that keep its access costs relatively higher than other IXCs, *if* those rules make it easier for AT&T to compete against *us* in the access market. For example, AT&T, with roughly sixty percent of the switched long-distance market, now generally opposes volume discounts. AT&T particularly opposes volume discounts for switching. See AT&T, pp. 27-29.

Now, more than ever, our biggest "customers" are also our biggest competitors. Anticompetitive price controls benefit them in both guises. As customers, they can continue to benefit from access rates that are too low; as competitors, they will enter markets where access rates are too high.

As a rule of thumb, it would be entirely reasonable for the Commission to infer where competition exists merely by noting what services our competitors argue most strenuously should continue to be subject to strict price controls. Switching is one such service. In its comments, ICG states that it serves thirty-two major markets and "has installed 13 high capacity digital switches throughout its networks that enable ICG to offer interstate transport and switched access services." (ICG, p. 1.) (In its comments, USTA says that in California ICG serves Anaheim, Burbank, Canoga Park, Compton, Davis, Fremont, Garden Grove, Los Angeles, Mountain View, Newport Beach, Oakland, Ontario, Orange, Rancho Cordova, Riverside, Sacramento, San Francisco, Santa Ana, Sherman Oaks, Walnut Creek, and Woodland Hills.) This utterly refutes Cox's assertion that "[t]here is absolutely nothing in the record to lead the Commission to a conclusion that the marketplace

for local exchange service is competitive" (though it bears out our rule of thumb). (Cox, p. 8.) ALTS projects that its members will have more than 100 competitive switches operational by the end of the first quarter of 1996. By 1998, it forecasts $6 billion in switched access and $5 billion in switched services, including resale.[7]

IV. The Cost of Access and the Elimination of Subsidies

MCI claims that "the LECs' true economic cost for providing access services is well below the current rates," and that the profitability of access services proves the lack of "consistent, across-the-board competition." (MCI, pp. 5, 7.) LDDS WorldCom agrees. "The LECs' own data demonstrate that access rates greatly exceed the underlying economic cost of using the LEC network, which is itself declining." (LDDS, p. 35.) CompTel says, "access charges currently are priced well above cost." (CompTel, p. 5.) Chairman Hundt,

[7] *Telecommunications Reports,* vol. 61, no. 44, Nov. 6, 1995, pp. 1-2.

too, has said that access services are set "way above cost."[8] (All of these comments, of course, relate to *carrier* access charges.)

First, to put things in perspective: the average price per conversation minute of access that IXCs pay has declined from $.1405 in 1986 to $.0605 in 1995.[9] At roughly the same time, according to the Commission's market share report, toll revenues in the IXC industry increased from $42.6 billion in 1985 to $67.4 billion in 1994.[10] The Commission's policies of the last decade have caused a tremendous increase in the value of the interexchange market, a reduction in that of access.

Next, to define the real issue: nobody disagrees that carrier access prices have been set above marginal cost. But carrier access prices have not been set above cost because we have exercised market power. Carrier access charges are priced above cost because of Commission dictates and policies. The Carrier Common Line Charge ("CCLC")

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[8] See *Telecommunications Reports,* December 11, 1995, p. 16. It is worth stopping to ask what "way above cost" means. Because of the large up-front investment that is required to provide service, the gross margins, operating profits, or earnings before interest, taxes, depreciation, and amortization ("EBITDA") from telecommunications concerns will always be higher than in most industries. (This is same point -- albeit expressed in accounting terms -- that economists make when they say that the difference between variable costs and service prices in a business with high fixed costs must, on average, be high in order to pay those high fixed costs.)

The following, taken from AT&T's annual reports, are AT&T's gross margins on telecommunications services for the last five years.

1994	1993	1992	1991	1990
41.8%	39.0%	37.2%	34.9%	33.0%

AT&T has said that its incremental network costs are "approximately $0.01 per minute of use." Initial Brief of AT&T Communications of California, Inc. (U 5002 C), A.88-07-020, A.88-08-051, and A.89-03-046, filed June 18, 1990, p. 45.

[9] *Seventeenth Monitoring Report,* CC Docket No. 87-339, May 1995, Table 5.11.

[10] FCC Report, "Long Distance Market Shares," 1st Quarter 1995, May 1995, Table 5.

is an obvious example. Less obvious are the lingering effects of a half-century of arbitrary processes, such as separations, depreciation, cost allocations, and fully distributed revenue requirements, that were often specifically intended to prevent rates from reflecting their economic cost or market value. Geographic averaging is yet another example of a policy that prevents rates from reflecting costs.

Finally, what to do about it: however well-intentioned, the general effect of these Commission policies has been to retard competition. But not because they result in access prices above cost. *All successful competitive enterprises with more than one product have some products priced above cost.* The rules retard competition because they subject competitive services to comprehensive price controls, as if they were still monopoly services.

Having now embraced competition, the Commission's challenge is to eliminate rules that assumed the absence of competition, not to fine-tune them. The LECs are in an unenviable position. Barred from the fastest-growing part of the telecommunications business, their inflation-adjusted access prices reduced by two-thirds since divestiture, they have been subjected to competition without meaningful relief from rules that assumed a monopoly. It now appears likely that we will be allowed into the long distance business. But when and on what conditions we do not know, and *not* before long distance competitors are allowed into the local exchange. In California, full competition for all services was made legal on January 1, 1996. Certification, together with all the rules and unbundling deemed necessary to allow competition, is pending. Subscriber lines will be resold beginning March 1, 1996. Loops are expected to be unbundled beginning April 1,

1996. Our unbundling agreement with MFS, as filed with the CPUC for state approval, is attached to these Reply Comments as Attachment C.

With competition increasing, the rebalancing of carrier access charges has become a matter of some urgency. The most obvious example is the CCLC, a Commission-mandated subsidy from carriers to end users. In our Comments we advocated eliminating the CCLC and recovering it either through an increase to the EUCL or in bulk-billing. In California, when intraLATA toll competition became legal we were directed to eliminate the CCLC and increase other rates.[11] Our average charge for originating and terminating an intrastate call is now just $.027 per minute. Our switched access rates are substantially less than other regions of the country. The portion of Ohio served by Ameritech is at $.0453 per minute for both ends of a call. Pennsylvania is at $.066. New York is at $.078. New Jersey is at $.082. Texas is at $.116.

Our interstate carrier access rates -- which must include the CCLC -- are also substantially lower than the nationwide average (about $.038 for both ends of a call, vs. $.055).[12] Unfortunately, the Commission's rules call for exactly the same switched access rate structure in *every* part of *all* regions.

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[11] See *Alternative Regulatory Frameworks for Local Exchange Carriers,* CPUC D.94-09-065 (*mimeo*, September 15, 1994), p. 121: "the CCLC ... was designed not to recover revenues from cost-causers, but to shift the burden for NTS costs from local exchange subscribers to toll users.... The foundation of this proceeding was to respond to increased toll competition by moving rates closer to costs. This has necessarily required us to move away from below-cost pricing for basic exchange services ... As part of the revenue rebalancing, the revenues lost due to the elimination of the CCLC must be counterbalanced by increased revenues from other services, including basic exchange services."

[12] Includes premium CCL and traffic sensitive charges, for a circuit of 10 miles.

Sprint agrees with us that there should be an alternative to the CCLC for recovering common line costs. The phase-out of CCLC and increase in EUCL that Sprint proposes is one acceptable way to eliminate the CCLC. If the CCLC continues to be recovered from carrier access customers, we should have the option to bulk-bill it, rather than charge by usage. Sprint also agrees with us that zone density pricing should be available for CCLC both to recover costs appropriately and to meet competition.

In our Comments, we proposed that in competitive areas, we be permitted to offer access services under nondiscriminatory contracts. There would be no limits on resale, and even in competitive areas customers would continue to have the option of ordering services from general tariffs. We would retain the same degree of upward pricing flexibility in tariffed rates that we have today -- no more. Our proposal is not revolutionary. It is closely analogous to the way AT&T's competitive discounts and promotions were treated.[13]

It would be preposterous to contend that the introduction of competition (which the Commission has facilitated by its dictates) has erased any obligation on the Commission's part to give us an opportunity to recover our costs (costs that were also incurred to satisfy regulatory dictates). Yet this is the upshot of what our competitors propose: geographically-averaged controls on access prices, without any additional pricing

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[13] See *Policy and Rules Concerning Rates for Dominant Carriers*, CC Dockets 87-313, 93-197, Further Notice of Proposed Rulemaking, FCC 95-198 (released May 18, 1995). The Commission decided that the revenue effects of Basket 1 promotion and optional calling plans (OCPs) should continue to be reflected in AT&T's price cap formula because they exhibited "substantial cross-elasticities of demand, and are generally offered to the same class of customers" as other price cap services. Likewise, under our proposal, access services under contract and access services under tariff would have substantial cross-elasticities of demand and would be offered to the same class of customers.

flexibility. In high-cost areas, they would continue to enjoy low averaged rates. In high-margin areas, they could continue to undercut us.

More than two decades ago, AT&T pointed out that it was inconsistent to introduce competition on the one hand, but maintain rules that prevented AT&T from responding to competition on the other. AT&T further pointed out that this inconsistency would make it impossible for it to remain in business and recover its total costs. Though it could not keep competition out of long distance, AT&T won that argument.[14] That AT&T should have a fighting chance to recover its total costs and still meet competitive entry targeted to its most profitable markets became a central tenet of the Commission's regulation of AT&T. That chance is all we ask.

In no event should the Commission heed those who advocate that access or interconnection services be priced at direct cost. (See, for example, CompTel, p. 19.) As Dr. Harris explained in testimony to the CPUC (Attachment B to these Reply Comments), to *require* that a service be priced at direct cost merely because competitors purchase it is never justified -- even when an essential facility is involved. The reasons for this are both legal and economic. (1) In violation of the "takings" clause, it would deprive the owner of the facility of reasonable compensation for its use. The owner would forgo the contribution to overheads that would have been earned by retailing the service to customers, without receiving any such contribution from competitors. (2) To promote economic efficiency, if the owner's retail customers pay prices that include a contribution to overheads, so should the owner's competitors. Otherwise, customers merely receive distorted price signals, and

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[14] See *MCI v. AT&T,* 708 F.2d 1081 (7th Cir. 1983).

the owner (who may be the market's most efficient provider), disadvantaged in the retail market and robbed of any contribution to overheads from the wholesale product, may go out of business.

Non-essential facilities should never be *required* to be offered to the owner's competitors at *any* price. Essential facilities should be priced at direct cost *plus* the contribution to overheads that is forgone by wholesaling them. In his testimony to the CPUC, Dr. Harris discusses the applicability of the essential facilities doctrine to our network. (Attachment B, pp. 53-59.)

V. Total Cost Recovery and "Discrimination"

In the *Second Notice,* the Commission defines "competitive harm in terms of the ability of a LEC to prevent prices paid by access customers from moving toward their efficient economic cost." (*Second Notice,* para. 28.) This should be understood to describe what actually happens in competitive markets. It should not be understood to mean that all access prices should recover their incremental costs and no more.

There is one dilemma that all competitive firms face: how to recover their *total* firm costs (some of which are not allocable to any one product or service) while competition drives the prices of their products or services toward *incremental* costs. The way that a firm resolves this dilemma is, literally, its secret of remaining in business. In competitive markets, multi-service firms typically recover the difference between incremental costs and the total costs of producing all services by pricing according to the differences in demand elasticities between the services. Services with less elastic demand are priced to produce higher margins, that is, to contribute more to the firm's total costs. AT&T, for example, said in its 1993 annual report: